ATLANTIC PROVINCES ECONOMIC COUNCIL | CONSEIL ÉCONOMIQUE DES PROVINCES DE L'ATLANTIQUE

Commentary

What Would YOU Do With $56 billion?

By David Chaundy, Senior Economist, APEC

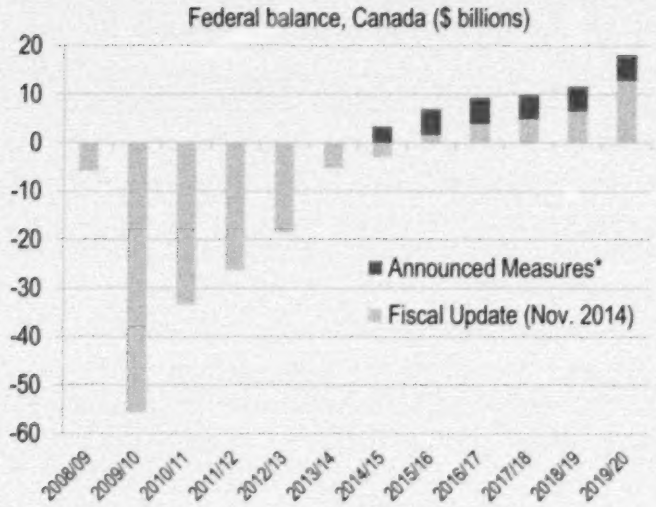
The federal government's Fall Fiscal Update, released on November 12, 2014 revealed a projected $56 billion in surpluses over the next 5 years, beginning in 2015/2016.[1] What would you do with $56 billion? Or, since the government is not going to make you and your friends into overnight billionaires, how would you use these projected surpluses to advance Atlantic Canada's economy? If you were the federal finance minister, would you cut personal income taxes, increase transfers, boost program spending or simply pay down the debt? This was the question I posed at APEC's recent business Outlook conference to stimulate delegates to think about what initiatives would most benefit this region.

Let me provide some context to help you formulate a response to this question. First, these surpluses are not that big. On an annual basis, they amount to about $312 per person – at $26 per month they are not going to make anyone rich. If the cumulative surplus over five years was allocated on a per capita basis, Atlantic Canada would only receive a total of $3.7 billion.

Second, the federal government has already allocated $26 billion. Prior to the fiscal update, the federal government announced the Small Business Job Credit (for 2015 and 2016); a doubling of the Children's Fitness Tax Credit which will now be refundable; the Family Tax Cut (income splitting for couples with children at home, which has its proponents and opponents); and various changes to child benefits, tax credits and expense limits. In addition, on November 27, the government announced increased infrastructure investments that reduce the surplus by a further $1.3 billion over the next five years. Unless you want to reverse these initiatives, the government has only left you with $30 billion to play with.

[1] At APEC's recent business Outlook conferences held prior to the Fall Fiscal Update, I used the number $66 billion, which was based upon estimates prepared by TD Economics in early October. The $56 billion is the comparable number, using the federal governments updated forecast released on November 12, 2014. The lower number largely reflects the decline in oil prices between early September and mid-October and the federal government's assumption that crude oil prices will remain at these lower levels throughout the 5-year forecast period.

How Will the Federal Government Allocate its Upcoming Surpluses?



The federal government forecasts surpluses averaging $11.1 billion per year over the next five years (for a total of almost $56 billion).

Through recent announcements, it has already allocated $26 billion of this total.

Source: Finance Canada

* Includes the Small Business Job Credit, the Children's Fitness Tax Credit, the Family Tax Cut, various changes to child benefits, tax credits & expenses, and new infrastructure investments.

Third, oil prices have fallen since the fiscal update which means that the projected surpluses are likely to be smaller than the government forecast, at least for the next two years. In its Short-Term Energy Outlook released on December 9, the US Energy Information Administration (EIA) forecast an average price for West Texas Intermediate (WTI) of US$63 per barrel for 2015, well below the US$81 per barrel assumed to prevail in the fiscal update. Oil prices remain volatile but if prices remain near the level currently forecast by the US EIA, it could shave a further $2.5 billion per year off the projected federal surplus.[2] For 2015/2016 this would be sufficient to push the projected surplus of $1.6 billion back into deficit, unless the $3 billion set-aside for contingencies is utilized.

Fourth, the table below shows estimates by TD Economics of the cumulative cost over five years of various tax and spending measures that you could make.[3] This table is not exhaustive but clearly illustrates that choices have to be made: you can't afford to do everything, even if oil prices quickly recover.

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[2] These estimates are based on forecast adjustments made in the fall fiscal update. The economic forecast for the federal government's fiscal update was based on a survey of private sector economists undertaken in early September, which was consistent with US WTI crude oil prices of about US$98 per barrel in the fourth quarter of 2014. Based on the decline in oil prices between September and mid-October, the government assumed that oil prices would average US$81 per barrel over the next five years. They therefore reduced the private sector forecast of nominal GDP by $16 billion per year beginning in 2015/2016, which reduced the fiscal balance by $2.5 billion per year.

[3] TD Economics (2014). *The Trouble with Surpluses: An Examination of the Federal Fiscal Outlook*. October 7. Accessed at http://www.td.com/document/PDF/economics/special/Federal_Fiscal_Outlook.pdf.

What Would You Do With $56 bn?

Fiscal Measure	Cost ($ bn)	Cumul. ($ bn)
Small Business Job Credit (2015-2016)*	0.5	0.5
Double Children's Fitness Tax Credit*	0.1	0.6
Family Tax Cut (income splitting)*	10.3	10.9
Child care benefit and tax changes*	13.4	24.3
New infrastruture investments*	1.3	25.6
Introduce Adult Fitness Tax Credit**	1.0	26.6
Double Tax Free Savings Account contribution limit**	2.3	28.9
Reduce lowest income tax rate (1 percentage point)	15.5	44.4
Reduce other income tax rates (1 percentage point)	19.2	63.6
Reduce GST (5% to 4%)	36.7	
Enhance Working Income Tax Benefit	2.7	66.3
Reduce corporate income tax rate (15% to 14%)	14.7	81.0
Increase program spending growth (1% per year)	6.3	87.3
Restore Canada Health Transfer escalator to 6%	4.0	91.3

Source: Finance Canada, TD Economics, APEC

* Already announced ** 2011 Conservative Platform

Broad based tax cuts are expensive. A one percentage point reduction in all four federal income tax rates would cost about $35 billion, with a similar cost for a one percentage point reduction in the GST. Reducing the corporate income tax rate from 15% to 14% would cost about $15 billion. More targeted tax changes, such as enhancing the Working Income Tax Benefit, would be more feasible. After a period of income restraint, increasing the growth rate of program spending by 1% per year above current projections, would cost $6 billion. Restoring the national escalator for the Canada Health Transfer to 6% from 2017/2018 onwards would amount to $4 billion.[4]

Reducing the debt is another option. If the remaining $30 billion in accumulated surpluses are used to reduce the debt, the debt-to GDP ratio would fall from its current 31.5% to 24.4% in 2019/2020. However, if the remaining $30 billion in projected surpluses are fully allocated to tax cuts, the debt-to-GDP ratio would still fall to 25.6% by 2019/2020 and would easily meet the government's longer-term target of a 25% debt-to-GDP ratio by 2021.[5]

[4] Beginning in 2017/2018, the total size of the Canada Health Transfer will grow in line with the overall economy which is expected to be much less than the current 6% national escalator.

[5] The debt-to-GDP ratio may fall faster if the annual $3 billion set-aside for contingencies is not required and is then used to reduce the federal debt.

A couple of conference delegates also asked me what I think the federal government should do. Here's my response. While we might all appreciate a lower tax burden, given the limited size of the available surplus I am not convinced broad-based personal income tax cuts would have much transformational impact in the Atlantic region. And the federal debt-to-GDP ratio will still fall to 25% by 2021 without more aggressive debt repayment. Instead, I suggest the following three priorities.[6]

Adjust transfers to the provinces. The federal government is facing a string of budget surpluses and by tying the size of transfer programs such as Equalization and the Canada Health Transfer to the growth in the overall economy, the federal government has provided itself with greater fiscal certainty and largely insulated itself from the fiscal impacts of population aging. This is not the case at the provincial level. According to the Parliamentary Budget Office's *Fiscal Sustainability Report 2014*, subnational governments will need to immediately and permanently increase taxes or reduce spending by 1.7% of GDP if they are to stop their debt-to-GDP ratio from increasing over the next 75 years.[7] This fiscal gap is largely due to the rising cost of health care due to an aging population and other cost pressures. The Parliamentary Budget Office estimates that if the Canada Health Transfer continued to grow at 6%, it would largely eliminate the aggregate fiscal gap of subnational governments although it would create a small fiscal gap for the federal government equivalent to 0.4% of GDP. Maintaining the Canada Health Transfer escalator at 6% would yield an additional $255 million to the Atlantic Provinces over the next five years.[8]

In addition to concerns about the appropriate escalator for the Canada Health Transfer, its current allocation on an equal per capita cash basis does not account for differential health care costs across the country. For example, the population aged 65 and over accounts for almost half of health care spending in Atlantic Canada, but this age group represents a much larger share of the population in the Atlantic region (17.5%) than nationally (15.5%). If the allocation formula was adjusted so that the Canada Health Transfer was distributed on an equal per capita basis for the population aged 65 and over with a smaller equal per capita transfer for the population under 65, then Atlantic Canada would gain an extra $110 million in this fiscal year.[9]

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[6] The second and third priorities could be phased in, or postponed by a year or two, if oil prices eliminate the available surplus in the next two fiscal years.

[7] Office of the Parliamentary Budget Officer (2014). *Fiscal Sustainability Report 2014*. Accessed at http://www.pbo-dpb.gc.ca/files/files/FSR_2014.pdf. This measure of the fiscal gap is an aggregate for all subnational governments. The ten provinces are currently in very different positions in terms of their fiscal balance and debt-to-GDP ratios, being generally stronger in the West and weaker in the East.

[8] The total cost to the federal government would be $4 billion.

[9] There would be no net cost to the federal government as such a proposal only changes the allocation formula. To minimize the impact of the policy change in jurisdictions with younger populations, such a change could be phased in over time or the total size of the transfer could be increased. High overall health care spending in the territories, despite their younger population, suggests they may need separate treatment or another cost driver needs to be included in the funding formula. Marchildon and Mou (2014) calculate an age-adjusted Canada Health Transfer using 5-year age groups and estimate that this would provide Atlantic Canada with an extra $152 million. They also advocate for a measure that accounts for the higher cost of delivering health care to remote and geographically dispersed populations. Their dispersion measure would provide Atlantic Canada with a further $78 million. Marchildon, Gregory and Mou, Haizhen (2014). A Needs-Based Allocation Formula for Canada Health Transfer. *Canadian Public Policy*, vol. 60, no. 3, September, pp. 209-223.

Increasing the Canada Health Transfer will not boost growth in the Atlantic region. But the persistent pressure to increase revenues or reduce other spending will work to undermine growth in the long-term. The Atlantic provinces already have the highest rates of corporate income tax (and some of the highest rates for personal income tax) in Canada but they have limited fiscal capacity to make changes that might support longer-term growth. Downloading the fiscal pressures of an aging population to the provinces does not solve the underlying problem. A more equitable sharing of the fiscal gap, and working with the provinces to ensure health care can be sustainably provided across the country, would improve outcomes for all.

Ensure sufficient infrastructure funding. A recent (and what proved to be a very temporary) water main leak in my community reminded me how dependent we are on key infrastructure. As we headed to the store to buy some bottled water (as we did not know at the time how long we would be without water), I reflected upon how we take for granted our access to basic services provided by public infrastructure. How long would we survive without clean drinking water, waste water removal, electricity (remember Hurricane Juan?) and our network of roads and bridges (remember last winter's potholes?) for the movement of people and goods.

There are numerous estimates of the "infrastructure deficit" in Canada. The Federation of Canadian Municipalities, in collaboration with three other organizations, estimated the replacement cost of municipal roads, waste water, drinking water and storm water assets in Canada that are currently assessed as being in "fair", "poor" or "very poor" condition at $172 billion.[10] The Canadian Centre for Policy Alternatives estimated that underinvestment in infrastructure in Canada amounted to a gap of $145 billion: Canada needs to spend $20-30 billion a year for ten years on top of current spending to return infrastructure spending to historic levels.[11] Using the recent federal infrastructure announcement as a guide, additional federal cash infrastructure spending of $10 billion per year over the next five years would reduce the federal surplus by a cumulative $12.5 billion.[12] If distributed on an equal per capita basis, this would provide Atlantic Canada with an additional $670 million annually. But if distributed according to need, the Atlantic provinces would receive proportionately more due the region's older public infrastructure.[13]

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[10] Federation of Canadian Municipalities, Canadian Construction Association, Canadian Public Works Association and Canadian Society for Civil Engineering (2012). *Canadian Infrastructure Report Card. Volume 1: 2012 Municipal Roads and Water Systems*. Accessed at: http://www.canadainfrastructure.ca.

[11] Hugh Mackenzie (2013). *Canada's Infrastructure Gap Where It Came From and Why It Will Cost So Much To Close*. Ottawa: Canadian Centre for Policy Alternatives. Accessed at: https://www.policyalternatives.ca/publications/reports/canadas-infrastructure-gap.

[12] On 27 November 2014 the federal government announced cash spending on infrastructure of $5.3 billion over the next 5 years (out of a total $5.8 billion), which would reduce the budgetary balance by a cumulative $1.3 billion over this period due to the amortization of capital spending.

[13] According to analysis by Statistics Canada, the average age of public infrastructure (including highways and roads, bridges and overpasses, water supply systems, wastewater treatment facilities and sanitary and storm sewers) in the Atlantic provinces is older than the Canadian average with the exception of Prince Edward Island. However, this reflects the impact of the Confederation Bridge. Prior to 1991, the age of public infrastructure in Prince Edward Island was also older than the national average; the province still has the older wastewater assets in Canada. Gagnon, Mychèle, Valérie Gaudreault and Donald Overton (2008). *Age of Public Infrastructure: A Provincial Perspective*. Analysis in Brief. Ottawa: Statistics Canada. Accessed at http://www.statcan.gc.ca/pub/11-621-m/11-621-m2008067-eng.htm.

Investment in maintaining existing infrastructure is not going to transform our region's growth. But, just like a household, it could cripple us if we have to unexpectedly respond to an aging roof or a rusty oil tank that is leaking, simply because we could not afford to replace our roof or oil tank before they gave out. Ensuring governments at all levels have sufficient resources to maintain and renew critical and strategic infrastructure remains vital for the health of Atlantic Canada's economy.

Focus on globally competitive innovation. The previous two priorities highlight areas that need attention so we don't drown in debt; my last priority focuses on what we need to help grow our economy. Our research on global value chains has been validated numerous times by industry speakers at our annual business outlook conferences.[14] What is critical for this region's growth are firms that are export oriented and that have differentiated their products and services in the global market through their proprietary technology, specialized competencies or superior quality of their products or services (e.g. more durable products, better environmental characteristics or faster turnaround). These firms are continually innovating, investing in R&D or machinery and equipment, and making sure they stay in touch with the latest market trends.

We have many such successful businesses who are often global leaders in their particular field, but we need these firms to grow by expanding their global reach and we need more of these types of firms. According to Statistics Canada's *Survey of Innovation and Business Strategy*, Atlantic firms have the lowest rates of innovation and use of advanced technologies in Canada and are the least likely to export and be otherwise engaged in global business activities.[15]

The mechanisms to achieve this will be varied and do not necessarily imply direct corporate subsidies.[16] But providing an environment that supports innovation leading to the creation or growth of globally competitive firms is crucial. Additional program spending or tax incentives of $5 billion over five years could include policies and programs that: encourage technological advances and commercialization of new approaches by sharing knowledge and expertise; expose local firms to international best practices; help firms access private sector funding and mentoring; facilitate collaboration amongst small firms so they can share specialized services or undertake joint marketing in global markets; assist the hiring of skilled workers with specialist skills (which may include global marketing as well as technical expertise); and help firms with contacts and information as they enter unfamiliar global markets and seek to identify strategic partners.

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[14] APEC (2011a). *Succeeding Globally: The Importance of Global Value Chains for Small and Medium-Sized Businesses in Atlantic Canada*. Halifax: APEC. APEC (2011b). *Taking on the World: Atlantic Canada's Role in Global Value Chains*. Halifax: APEC.

[15] Statistics Canada (2014a). Survey of Innovation and Business Strategy, 2012: Innovation in Canada. *The Daily*, February 14. Statistics Canada (2014b). Survey of Innovation and Business Strategy, 2012: Global Value Chains. *The Daily*, March 10.

[16] In contrast to businesses elsewhere in Canada, Atlantic firms are more likely to cite grants rather than tax credits as the most critical public program to support their innovation.

The federal government launched its pre-budget consultations on November 27. I've shared my three priorities. Assuming oil prices don't completely eliminate the room for new fiscal initiatives, it's now time for you to start thinking about how you want the federal government to allocate its upcoming surpluses.

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